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SIPDIS

TREASURY FOR INTERNATIONAL AFFAIRS - RADKINS AND MMILLS
NSC FOR BRYZA AND MCKIBBEN

SENSITIVE

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TAGS: EFIN ECON TU
SUBJECT: Turkish Markets Uneasy Over EU News Flow

Sensitive But Unclassified.

This cable has been coordinated with Congen Istanbul.

¶1. (SBU) Summary: As analysts had long expected, the approach of the December 17 EU decision is generating increased volatility in Turkish financial markets. A market-worrying flow of news on the EU front was the leading factor in a sell-off during the last few days in November. Though markets have recovered, they remain nervous and reactive to news flow. The market turbulence comes just as some recent data suggest a less troubling current account deficit outlook. End Summary.

Sell-off followed by Recovery in Turkish markets:
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¶2. (SBU) During the last few days of November, and particularly on Tuesday, November 30, Turkish markets turned down, largely over negative news flow relating to Turkey's EU accession process (see below). The stock market, for example, fell 2.12% on Monday and a further 1.37% on Tuesday. In the domestic bond market, critical for the GOT's financing needs, the interest rate on the benchmark bond rose about 130 basis points from 22.99% at the close on November 24 to 24.29% at the close on November 30. The change on November 30 (94 basis points) was the most pronounced. Beginning, December 1, however, stock and bond markets began to recover, with the benchmark interest rate easing most of the way back to 23.33% at the close December 2 and the stock market rallying 2.61% that day to 23,150, not far off the 23,293 level in hit November 25.

¶3. (SBU) Over the past few weeks, the lira has moved with the Euro, strengthening against the dollar. November 30 was one of the few days in recent weeks in which it depreciated against both the dollar and euro: from TL 1.4262 million to the dollar to TL 1.4329, and from TL 1.8906 million to the euro to TL 1.9020. According to several local analysts, the November 30 lira depreciation came despite local factors that would have tended to strengthen the lira, in particular demand for lira for tax payments and a general environment of lira illiquidity. Given these local factors, the fact that the lira depreciated at all is noteworthy.

Discouraging News Flow on Turkey's EU Prospects...
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¶4. (SBU) Market analysts overwhelmingly attribute the sell-off to the flow of disquieting news relating to the December 17 decision by the EU Council on whether and under what conditions to begin accession negotiations with Turkey. In particular, analysts point to the leak of a Dutch draft EU Council statement which was interpreted as requiring Turkey to extend its longstanding association agreement with the EU 15 to the ten new members who joined on May 1, including the Republic of Cyprus. This is considered politically difficult, if not impossible, for Turkey to do prior to December 17 since it some in Turkey have spun this as tantamount to recognition of the (Greek) Republic of Cyprus. The leaked draft contained other elements that are considered very difficult for the GOT to swallow: the possibility of permanent limits on Turkish migration to other EU members and lowering the share of EU members needed to suspend negotiations from 2/3 to 1/3. Other Turkey-negative news in recent days included calls by the Austrian Prime Minister for open-ended negotiations with Turkey and the confirmation of Nicolas Sarkozy--who opposes full EU membership for Turkey-- as leader of the ruling UMP party in France. Though analysts all attributed a lead role in the market uneasiness to the EU-related news, some also mentioned continued uncertainty over the status of Turkey's IMF negotiations, and heightened frictions with the U.S. over Iraq as factors.

...Put in Context by Market Analysts...

¶5. (SBU) Most analysts we spoke to sought to put the sell-off in context. When asked why he did not even mention the sell-off in his daily electronic newsletter, Deutsche Bank's Tevfik Aksoy said he tried to avoid commenting on day-to-day movements, particularly since the volatility in the run up to December 17 was long expected. Citigroup's Olga Buyukkayali called the downturn a buy opportunity. Other analysts, echoed Foreign Minister Gul's comment that the leaked draft will be one of many, and downplayed its importance.

¶6. (SBU) Though many analysts downplayed the significance of the recent negative news and the sell-off and all expect some sort of conditional "yes" from the EU they all worry about the EU imposing overly difficult conditions and the potential reaction by Turkish politicians. Global Securities' Cem Akyurek wondered why markets were not more alarmed, given that the leaked draft included several features that Turkey could not accept. Emin Ozturk of Bender, commented on markets "selective perception" of events, which in the past year or two has mostly focused on the positive news and ignored the negative. He thought the flow of negative news finally reached a tipping point that the market could not ignore. Put another way by Attila Yesilada and Murat Ucer of Eurosource, the markets could be "switching from pricing in the positives to discounting a combination of a "maybe" from EU on December r 17th, delay in the IMF standby, rising long-yields and loss of US support because of Iraq."

...Who Point out some Encouraging Macro Signs:

¶7. (SBU) Ironically, the sell-off came just after the market-positive announcement of October trade figures. Exports up to a record $5.7 billion and while imports continued to grow (to $8.0 billion), the rate of import growth decelerated. The ratio of exports to imports improved slightly to 70%. Combined with reports of another good month for tourism, the October trade numbers are positive for markets worried about Turkey's growing current account deficit. On December 1, the exporters' association announced its unofficial number for total exports in November: at $5.8 billion, again a positive sign. Late on December 2, the Central Bank announced a $232 million current account deficit for October, broadly in line with expectations.

¶8. (SBU) Also good for the current account deficit outlook has been the fall of the dollar against the euro, and market expectations for continued dollar weakness. Deutsche Bank's Aksoy points out that more than 50% of Turkey's exports go to the Euro zone. Aksoy and other analysts also point out that a higher proportion of Turkey's imports (55%) are dollar-denominated than Turkey's exports (57% Euro-denominated): in addition to oil imports, many inputs in Turkey's manufacturing industries come from East Asia and tend to be dollar-linked.

¶9. (SBU) Finally, there have been signs of a deceleration in the rate of economic growth, which is considered a positive because the very high rate of growth in the first half of 2004 (over 13 percent annualized) has been seen as unsustainable, sucking in imports and leading to a widening current account deficit. Among the signs of decelerating growth in October are lower auto sales, a fall in capacity utilization, and a decline in value-added tax collection.

¶10. (SBU) Comment: With volumes low and many players staying out of the markets in the run-up to December 17, Turkish markets are confused and highly reactive to EU-related news flow. But portfolio investors continue to bet on a relatively optimistic scenario. They are lured by the track record of high returns and the attractiveness of the EU "convergence play" and/or moral hazard bet on Turkey's importance to the West, even if they are increasingly hedging their positions against the severe market hit that could take place if December 17 doesn't turn out as they expect.
Edelman